

WHO WERE THE VILLAINS IN THE SUBPRIME CRISIS, AND WHY IT MATTERS

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“While there was some crime in the mortgage industry, law-abiding, respectable, upstanding citizens caused the overwhelming majority of financial losses suffered thus far. Skeezy money managers and mobbed-up boiler rooms didn't create the economic catastrophe. It was visited on us by firms in the Dow Jones Industrial Average and S&P 500—companies that trace their origins back to the 1800s, run by graduates of Yale and Harvard. The people who blew up the system weren't anarchists. They were members of the club: central bankers and private-equity honchos, hedge-fund geniuses and Ph.D. economists, CEOs and investment bankers.”¹

I. INTRODUCTION

The subprime crisis has morphed into a full-blown financial crisis, the worst since the Great Depression. We need, of course, to figure out how to return to financial health. We need, as well, to understand how we got into this crisis, with a view towards preventing or at least minimizing the severity of future crises. There are obvious ways of going wrong in such an inquiry. We can't just deal with last year's shoe or underwear bomber – next year's bomber won't be carrying the bombs, or toxic securities, in his shoe or underwear. There is some evidence that this lesson hasn't been learned well enough – but that's not the subject of this essay. Rather, this essay concerns another way of going wrong: succumbing to the temptation

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¹ Daniel Gross, *Dumb Money: The Villains of the Financial Catastrophe aren't Criminals. They're Morons*, SLATE, <http://www.slate.com/id/2211922/pagenum/all/#p2> (describing his book, DUMB MONEY: HOW OUR GREATEST FINANCIAL MINDS BANKRUPTED THE NATION). By “villains” Gross presumably means those responsible – the quote indicates that he is not attributing evil motives to the various actors he discusses.

to attribute what happened principally to “villains” or “greedy people.”² The crisis could not have occurred but for many people as to whom neither of those labels applies. Rather, market actors with standard market motivations were necessarily involved: people whose job is to create, structure, appraise, sell, or buy new financial instruments. These motivations can be, and not infrequently are, marshaled largely for the good. The people who created the first mortgage-backed securities in the 1970s were doing so to try to make a profit; they also managed to make mortgages more available at better and more uniform rates throughout the country, as well as providing a new type of investment product. Subprime mortgage securities made their creators, appraisers, structurers, buyers and sellers significant profits at first, and were also thought to make owning a home more feasible to a broader swath of the population.

Some of the market actors involved in subprime securitization can be criticized, especially for their behavior in the period just preceding the crisis. Many had glimmerings (or stronger indications) that the assumptions underlying subprime securitization were becoming more unrealistic; some may have suspected that the securities themselves were of far lower quality than those issued in preceding years, or at least that they didn't have any time to make a proper assessment of quality. They declined to act because they feared incurring significant costs — perhaps job loss, but perhaps only limiting their job advancement possibilities or the size of their bonus. Those with a direct stake in the value of the toxic securities -- - those who bought the securities, or made bets that the securities would hold their value-should perhaps have done more research and relied less on

² Dictionary.com defines greed as: excessive or rapacious desire, esp. for wealth or possessions. “*Greed*,” Dictionary.com, *available at* <http://dictionary.reference.com/browse/greed>. The use of the term in the context at issue is virtually unintelligible. What makes a desire for wealth ‘excessive’? Is it by reference to what (or who) one is seeking to get the wealth from? Does trying to profit from dealings with a poor person make one greedy? Is greed a function of (lack of) effort? Is trying to get money by playing the lottery “greedy”? Is the CEO who works extremely hard and wants 10% of the money she earned for the company- a huge sum- greedy? Is greed a function of how much one already has? Is this same CEO greedy because she already has enough money to never have to work again? Is greed a function of what one is offering in order to get the money compared to the thing’s “value”? What about trying to get money by raising the price of a service when it’s particularly needed (umbrellas during a rainstorm; snow shovels during a blizzard)? What about assessing high fees for even small overdrafts on a bank account? My best guess is that the wealthier one already is, the less effort one has to expend, the more one is counting on the stickiness of others’ practices or special circumstances, all else equal, the more apt one is to be considered “greedy.”

the pedigree of the securities' buyers and sellers.³ But private actors are entitled to act for themselves—and make “mistakes”—without warranting criminal sanction.

What follows from these observations? In brief, that preventing, or minimizing the likelihood or severity of, the next crisis cannot be accomplished purely or even principally by making now-legal behavior illegal or making now-illegal behavior more illegal.⁴ What the villains did was already largely illegal. Making this conduct more illegal won't help, nor will expending resources on detecting it. Indeed, enough was known at the time about the illegal practices that action could have been taken against them, had the will existed to do so. And nowadays, the villains have moved on to other scams. Furthermore, insofar as the conduct wasn't illegal, it depended on fooling people who, at least in the short term, “won't get fooled (in that way) again”—buyers of what are now called toxic securities who paid premium prices.

As importantly, it follows that market participants can act in ways that seem contrary to their self-interest, contrary to what traditional theory would suggest.⁵ One might think subprime investors would have been far warier of the securities than they were, and charged a far higher lemons premium. They knew, after all, that the securities were backed by mortgages to subprime borrowers; they knew that subprime mortgages had not been made in significant numbers until very recently, and hence there was very little performance data available; and they knew that the mortgage

³ I make the argument that the buyers should have done more of their own research and relied less on that of others in Claire A. Hill, *Why Didn't Subprime Investors Demand (Much) More of a Lemons Premium?* (2009) (working paper, on file with author).

⁴ This essay does not address the role more extensive government supervision might have played. In retrospect, and perhaps even in prospect, one can easily point to steps the government should and could have taken: significantly limit banks' ability to use leverage, regulate mortgage brokers, impose safety and soundness regulation on any financial institution originating loans, etc. But my concern here is with next year's shoe bomber. History strongly suggests that the present “flight to quality” will eventually recede, to be replaced by a “flight to yield.” At that point, we can expect to see more deal structures that supposedly offers more yield without commensurate risk, as the MBS and CDOs and CDSs were advertised to do. We can't know now what the government should do to prevent problems from such structures; however, we can believe that investors making more critically-minded decisions, as I argue for in Hill, *supra* note 3, would help.

⁵ This being said, my use of the term traditional theory is admittedly a bit of a caricature; traditional theorists have developed models of herd behavior, “rational frenzies,” and other related phenomenon. See, e.g., Jeremy Bulow & Paul Klemperer, *Rational Frenzies and Crashes*, 2 J. POL. ECON. 1 (1994).

originators had every incentive to price the mortgages too highly, as do all sellers. Buying the subprime securities could be consistent with self-interest if the buyers were simply agents who could earn a fee while foisting massive losses on others. But many investors were acting for themselves, and have suffered massive losses. And those who acted for others also lost: they lost fees, when their assets under management shrank and their funds suffered withdrawals. What this suggests is that more creative ways of dealing with the problem are needed—ones that aren't focused solely on punishing villains or aligning incentives.⁶

Many sensible strategies are being considered, including limiting financial institutions' ability to make huge bets and establishing mechanisms by which information about transaction volume and leverage can be collected in real time. In this regard, it might be possible to incentivize more market actors to do something akin to whistle-blowing, and report to regulators in a position to understand and act on the information suspicions the market actors may have about the quality of securities they are involved in structuring, selling, rating or buying, or pressure put upon them by their employers to inflate appraisals or ratings. Some other strategies might also be worth considering. Perhaps more money managers can be motivated to do independent research and rely less on what other money managers are doing, and what rating agencies are saying. Perhaps, regulation of appraisers and rating agencies can make both of them produce evaluations that are more expert and more unbiased.

Considering the intricacies of possible solutions is beyond the scope of this essay. My aim, instead, is to focus on the necessity of dealing with the market actors involved in the crisis—actors who cannot appropriately be demonized or viewed simply as bad agents making decisions in their short-term interest but against their principals' interests. Without these actors the crisis would not have occurred. It is therefore critical to try to understand why they acted as they did in this case, and how their behavior might be influenced to minimize the chance of future crises.

To that end, this essay provides an account of the mindset of market actors other than “villainous” ones, and considers in broad brush what sorts of mechanisms short of traditional legal punishments might be employed to affect such actors' behaviors in ways that might make crises less likely.

⁶ This is not to say that solutions involving incentive alignment shouldn't be considered. Richard Painter and I are advocating just such a solution—making highly compensated managers at financial firms partly personally liable should their firms become insolvent. See Richard Painter & Claire A. Hill, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have Some Personal Liability*, SEATTLE U. L. REV. symposium issue, *In Berle's Footsteps* (forthcoming 2010).

Section II provides some background on securitization, the technique that spawned the toxic subprime securities.⁷ Section III lists the main actors in the subprime crisis; it defines “villainy” and distinguishes villains in the crisis from the many non-villains. Section IV presents a stylized account of the market actors’ mindsets. Section V offers some suggestions as to how to deal with the non-villains, and concludes. A preliminary point should be made—the concept of “villains” is, of course, a fanciful one, not amenable to precise or rigorously defensible exposition. Similarly, my main argument about the non-villain actors is a characterization I (and some other commentators in the literature) have made, again without the possibility of empirical or other truly rigorous demonstration. My aim in this essay is to paint a picture that I hope will resonate – of the temptation to demonize, and the reasons not to give into the temptation.

II. SOME BACKGROUND ON THE SECURITIZATION OF SUBPRIME MORTGAGES

The present financial crisis has its origins in the subprime crisis. A stylized (and simplified) account of the subprime crisis follows.

Many mortgages were made to homebuyers and homeowners with less than stellar credit. These mortgages were sold into trusts, or pools; interests in the pools (securities, now also known as “toxic securities”) were sold to investors.⁸ Many people were making side bets on the performance of the mortgages and securities. And many other people were involved in structuring the pools, selling the interests, and appraising and rating the mortgages and the interests. Thus, the main market actors involved are brokers and originators involved in making mortgage loans, appraisers issuing appraisals to support the collateral value backing the loans, intermediaries packaging the loans for sale to ultimate investors as securities or providing expertise to support the packaging and sale (including rating agencies⁹), buyers of the securities, and those making side bets on the securities.

⁷ I follow usage in the press that characterizes the crisis relating to mortgage debt as the “subprime” crisis, and the securities at issue as “subprime mortgage securities,” even though many of the mortgages securitized were to borrowers with less than stellar credit that nevertheless was better than subprime. The technical name for such borrowers is “Alt-A.”

⁸ This vastly oversimplifies the characteristics of the toxic securities. Indeed, some securities were comprised not of mortgages but of other securities that themselves were interests in pools of mortgages.

⁹ By “rating agencies” I mean the three main rating agencies involved in rating the toxic securities, Moody’s, Standard & Poor’s, and Fitch.

That mortgage loans to lower-quality borrowers could readily be sold caused more such loans to be made, and caused them to be made to progressively lower quality borrowers. This in turn increased demand for real estate, contributing to a bubble. The crisis occurred when the bubble burst: the value of the securities, the underlying mortgages, and the houses securing the mortgages, declined precipitously. A brief stylized history of subprime securitization follows.

Securitization is a financing technique. It turns the rights to receive money ("receivables") into present cash. The receivables are sold to a pool; amounts owing are paid into the pool. Investors buy interests in the pool ("securities"). Each pool has different sorts of interests. One important dimension on which the interests differ is quality. A pool will sell the right to receive the amounts it receives first, the amounts it receives second, and so on, with someone having the right to get the remainder, if any.¹⁰ The quality of the securities is assessed by the major credit rating agencies, Moody's Investor Service, Standard & Poor's, and Fitch Investor Services.¹¹

Securitization started in the early 1970s.¹² The first securitizations involved mortgages made to prime customers. The mortgages were pooled and interests in the pool were sold to investors. The result was felicitous: mortgage rates declined overall, and became more consistent throughout the country, since banks were able to sell their mortgages into a national secondary market.

Structuring a securitization transaction entails making certain assumptions about how the receivables being pooled will perform. Is the person or entity who owes the money able and willing to make timely payments? Is there sufficient, or indeed any, underlying collateral or other source of repayment? How might any changes in the economy overall, or other macroeconomic factors, affect repayment? The more information there is on these points, all else equal, the more straightforward structuring the transaction will be, and the more likely it is that the interests will be

¹⁰ See generally Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L. Q 1061 (1996).

¹¹ See generally Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L. Q. 43 (2004) (for a history of the rating agencies).

¹² Receivables sales, in which someone owed money sells the rights to receive the money to someone else for immediate cash, have been occurring for a very long time. Securitization also involves a sale of receivables in exchange for immediate cash, but there are some significant differences. The pool offers different types of interests, it often includes receivables from many different obligors and initial obligees and may otherwise be diversified, and the buyers of pool interests are capital market investors. Hill, *supra* note 10, at 1067. For a history of the modern era of securitization, see Hill, *supra* note 10, at 1119-1126.

sold at a price that reflects an appropriate assessment of their risk/reward ratio.

Even as the first mortgage backed securities were being structured, a great deal was known about prime mortgages — about different types of borrowers, about how borrower behavior would be affected by changes in interest rates, etc. Knowledge increased considerably as time went on. Structuring standard mortgage-backed securities became “cookie-cutter.”¹³ Wall Street “rocket scientists” quickly moved beyond securitizing prime mortgages, and began securitizing receivables that were far less understood. Prime mortgage receivables are amounts prime borrowers already owe on their mortgages, secured by assets borrowers probably value a great deal, and third parties are apt to value considerably as well. The next type of receivable securitized in significant volume was credit card receivables. By contrast with prime mortgages, they have very little (if any) underlying collateral. Also securitized were future “receivables” where nothing was yet owed and might never be owed: toll road receivables, for instance. What if nobody drives on the highway? 1997 saw the advent of Bowie Bonds, rights to receive future royalty payments owing to David Bowie.¹⁴ How much in the way of royalties would be generated?

Many other examples can be given. In my article on securitization published in 1996, I listed the following types of receivables that had been securitized: “lease receivables (including automobile, equipment, and aircraft leases), trade receivables, commercial loans, defaulting loans, boat loans, loans to low-quality borrowers, loans to small businesses, insurance premiums, export credits, franchise fees, airline ticket receivables, toll road receivables, health care receivables, nursing home receivables, mortgage servicing rights, rights to royalties, and tax receivables.”¹⁵ The trajectory has continued, with many more types of receivables securitized in recent years.

In the late 1990s, Wall Street began securitizing mortgages made to borrowers who did not have “prime” credit. Origination of such mortgages had been a very small proportion of overall mortgage originations, but that quickly began to change. Markets anointed subprime securitization securities the “hot new thing.” The securities seemed to offer a very favorable risk/reward combination: the higher quality securities, those to be paid first, were rated AAA, but paid interest at rates significantly higher

¹³ Note that this account glosses over the role of Fannie Mae and Freddie Mac, quasi-government agencies that guaranteed mortgages and mortgage-backed securities. See generally Hill, *supra* note 10, at 1119-21 (discussing this aspect of the history of securitization).

¹⁴ See Daniel Kadlec, *Banking on the Stars*, TIME.COM, available at http://www.time.com/time/innovators/business/profile_pullman.html.

¹⁵ Hill, *supra* note 10, at 1076-7.

than other AAA rated instruments. With investors snapping up the securities made by pooling subprime mortgages, transaction volume of subprime mortgages increased precipitously.¹⁶ As lenders struggled to find more borrowers to whom to make loans, they increasingly lowered their credit standards. At the same time, housing prices were increasing, fueled in part by the fact that there were now more possible buyers, and by the perception that real estate was “hot.”¹⁷

Those structuring the securitization securities from subprime mortgages made assumptions as to how likely the mortgages were to be timely paid, and how much the underlying collateral — the real estate being purchased and mortgages — would be worth. The assumptions were not based on much data: unlike the situation with prime mortgages, where many had been made for a long time before they were securitized, there had been very few subprime mortgages made until they could be securitized. And the assumptions were very optimistic. The rating agencies rated the securitization securities highly, for reasons that have been extensively analyzed elsewhere and that I will discuss in Section IV. C below.¹⁸ For

¹⁶ Federal Reserve Chairman Ben Bernanke said: “In the past quarter century, advances in information technology, the development of credit-scoring techniques, and the emergence of a large secondary market, among other factors, have significantly increased access to mortgage credit. From 1994 to 2006, subprime lending increased from an estimated \$35 billion, or 4.5 percent of all one-to-four family mortgage originations, to \$600 billion, or 20 percent of originations.” Fed. Res. Chairman Ben Bernanke, Address to the Nat’l Com. Reinvestment Coal. Ann. Meeting (Mar. 14, 2008), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20080314a.htm> (last visited Nov. 4, 2009).

¹⁷ There is, of course, a huge literature supporting these propositions. For an illuminating account of the origins of the crisis, *see generally* Martin Neil Bailly, Robert E. Litan & Matthew S. Johnson, *The Origins of the Financial Crisis, Initiative on Business and Public Policy at Brookings*, THE BROOKINGS INSTITUTION (Nov. 2008), *available at* http://www.brookings.edu/papers/2008/11_orgins_crisis_bailly_litan.aspx.

¹⁸ *See also* Claire A. Hill, *Why Did Anyone Listen to the Rating Agencies After Enron?*, 4 MD. J. BUS. & TECH. LAW 283 (2009) and Claire A. Hill, *Why Did Rating Agencies Do Such A Bad Job Rating Subprime Securities*, forthcoming, U. PITT. L. REV. It is important to dispel an oft-made criticism—that the fact that securitization securities backed by pools of subprime mortgages were rated AAA by itself indicates the securities were misrated. A pool issues different tranches of securities in differing orders of priority. It is not as though a pool of 100 billion dollars of subprime mortgages issues 100 billion dollars of AAA rated securities. Rather, a pool will issue some AAA rated securities, those to be paid first, and securities to be paid only after the AAA rated securities are paid; moreover, additional credit enhancement is often used. This point is discussed further in Section IV. C, *infra*.

the first few years (through approximately 2005),¹⁹ as housing prices went up spectacularly, the assumptions were not called into question. But of course, this changed dramatically when housing prices stopped their dizzying trajectory upwards, and careened downwards instead, prompting a wave of defaults and foreclosures and other dramatically bad consequences that continue today. Before the collapse, though, not only were there securitization securities comprised of subprime mortgages being sold, there were also massive side bets—the “notional amounts” were in the tens of trillions of dollars—²⁰ being made on the performance on the securities; thus, the amount invested in making bets on subprime securities by investors and third parties was even greater than the aggregate amount of the actual securities outstanding.

III. THE MARKET ACTORS IN THE SUBPRIME CRISIS

Who were the market actors in the subprime crisis?²¹ Mortgage originators (both the brokers and the lenders); appraisers whose appraisals were used to underwrite the loans; investment banks who structured and sold (and sometimes bought) the instruments; law firms who helped them; rating agencies who rated the instruments; investors on others’ behalf, in mutual funds, hedge funds, and other investment vehicles, who took “long” and “short” positions in the instruments; investors on their own behalf; and insurers, including swap providers. Of course, the foregoing includes both the entities and the individuals involved (“investment banks” and “investment bankers,” for instance, and “law firms” and “lawyers,” the rating agencies and their employees, etc.).

Which ones were villains? Dictionary.com defines villain as “a cruelly malicious person who is involved in or devoted to wickedness or

¹⁹ Bailly, Litan & Johnson, *supra* note 17, at 20.

²⁰ Shannon D. Harrington & Abigail Moses, *Credit Swap Disclosure Obscures True Financial Risk*, BLOOMBERG, Nov. 6, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601109&sid=aKKRHZsxRvWs&refer=home>.

²¹ I do not separately consider “market actors” who were buying real estate as an investment or refinancing real estate they owned to make other investments. If they believed the value of their investments would appreciate, they aren’t much different from many of the home buyers or refinancers involved in the crisis who counted on appreciation of their houses to permit them to pay their monthly payments. If they “took the money and ran”—that is, they somehow tricked banks into lending more than the purchase price and pocketed the money, walking away from the house—they are “villains.”

crime; scoundrel.”²² Another online dictionary on Princeton University’s website gives the following definition: “a wicked or evil person; someone who does evil deliberately.”²³

Of course, “villain” is rather a fanciful word to use in this context; it is surely not amenable to anything like a precise or mechanical definition. For purposes of this essay, I characterize as villains those who sought to “take the money and run” in a manner that was illegal or nearly so.

An example is an executive of a public company who tells his stockholders that his company is quite sound, while knowing this to be false and also selling his own stock in the company. Or a mortgage lender who provides a borrower with a loan on terms much worse than the borrower had approved, and that the borrower would qualify for. We can construct a continuum of culpability of the various market actors. At one end are people who knowingly sought to profit at another’s expense, often through lies or deceptive conduct. At the other are people who bought subprime securities truly thinking they were good investments; they were trying to obtain immediate profits but also trying, in many if not most cases, to build a reputation for the moderate-term. Of course, the continuum could attempt to capture not just the “heart” but also the “head” – did the people who concluded that the subprime securities were good investments do appropriate research? But for purposes of this article I largely assume this issue away.

The next section presents a stylized account of the role and mindset of the relevant actors; the actors are arrayed on a continuum from most to least villainous.²⁴

IV. MINDSET OF THE MARKET ACTORS

A. *Mortgage Brokers and Originators*

The clearest examples of villains in the subprime crisis engaged in behavior that was clearly illegal.²⁵ A mortgage broker who added more fees to the loan documentation than what was on the documentation the

²² “Villain,” Dictionary.com, available at <http://dictionary.reference.com/browse/villain>.

²³ “Villain,” Princeton Wordnet Online Database, available at <http://wordnetweb.princeton.edu/perl/webwn?s=villain>.

²⁴ Of course, each category of actor is heterogeneous: it would be impossible to properly describe the many types of people within each category. That being said, certain generalizations can appropriately be made.

²⁵ See generally Gretchen Morgenson, *Lenders Who Sold and Left*, N.Y. TIMES, Feb. 3, 2008, available at <http://www.nytimes.com/2008/02/03/business/03gret.html>.

borrower reviewed, obtaining the borrower's signature on the new documentation by sleight of hand. A mortgage broker who lied about the borrower's income when selling the loan to a third party. An executive who instructed his company to make loans to progressively lower quality borrowers and touted the high quality of his company's loan portfolio in the company's public documents while selling his own stock.

Following are some examples:

From a Los Angeles Times account of the behavior of Ameriquest, a subprime mortgage loan originator: "In court documents and interviews, 32 former [Ameriquest] employees across the country say they witnessed or participated in improper practices, mostly in 2003 and 2004. This behavior was said to have included deceiving borrowers about the terms of their loans, forging documents, falsifying appraisals and fabricating borrowers' income to qualify them for loans they couldn't afford."²⁶

From the SEC's press release announcing their lawsuit against top executives of Countrywide, another mortgage loan originator:

On June 4, 2009, the Securities and Exchange Commission announced the filing of securities fraud charges against former Countrywide Financial CEO Angelo Mozilo, former chief operating officer and president David Sambol, and former chief financial officer Eric Sieracki. They are charged with deliberately misleading investors about the significant credit risks being taken in efforts to build and maintain the company's market share.

The Commission has additionally charged Mozilo with insider trading for selling his Countrywide stock based on non-public information for nearly \$140 million in profits.

...the SEC alleges that Mozilo, Sambol, and Sieracki misled the market by falsely assuring investors that

²⁶ Mike Hudson & E. Scott Reckard, *Workers Say Lender Ran 'Boiler Room'*, L.A. TIMES, Feb. 4, 2005, available at <http://www.latimes.com/business/la-fi-ameriquest4feb0405,1,7774916,full.story>. Note that falsification of income may be 'villainous' vis a vis the purchaser of a mortgage, but may not be so villainous vis a vis the borrower, insofar as it enabled the borrower to purchase a better home or get more money in a refinancing, something the borrower presumably wanted. Moreover, some borrowers knew about, and perhaps even encouraged or initiated, falsification of their income. See generally Mark Gimein, *Inside the Liar's Loan, How the Mortgage Industry Nurtured Deceit*, SLATE, April 24, 2008, available at <http://www.slate.com/id/2189576/>.

Countrywide was primarily a prime quality mortgage lender that had avoided the excesses of its competitors.

According to the SEC's complaint, Countrywide's credit risks were so alarming that Mozilo internally issued a series of increasingly dire assessments of various Countrywide loan products and the resulting risks to the company. In one internal e-mail, Mozilo referred to a profitable subprime product as "toxic." In another internal e-mail regarding the performance of its heralded Pay-Option ARM loan, he acknowledged that the company was "flying blind." ...

The SEC alleges that Mozilo, Sambol, and Sieracki actually knew, and acknowledged internally, that Countrywide was writing increasingly risky loans and that defaults and delinquencies would rise as a result, both in loans that Countrywide serviced and loans that the company packaged and sold as mortgage-backed securities...

Countrywide developed what was internally referred to as a "supermarket" strategy that widened underwriting guidelines to match any product offered by its competitors. By the end of 2006, Countrywide's underwriting guidelines were as wide as they had ever been, and Countrywide made an increasing number of loans based on exceptions to those already wide guidelines, even though exception loans had a higher rate of default. ...²⁷

The SEC complaint says that Mozilo's gains on his insider sales were over \$139 million.²⁸ The Wall Street Journal computes the amount Mozilo made for the period from July 1, 2003 to June 30, 2008, a period during which Countrywide's stock price declined by 91%, as follows: \$92,158,109 in cash compensation and \$378,528,752 in (net) proceeds from stock sales, for a total of \$470,686,861.²⁹

²⁷ SEC Files Securities Fraud Charges Against Former Countrywide Executives, Litigation Release No. 21068A (June 4, 2009), *available at* <http://www.sec.gov/litigation/litreleases/2009/lr21068a.htm>.

²⁸ Plaintiff's Complaint for Violations of the Federal Securities Laws at 46, *Securities and Exchange Commission v. Angelo Mozilo, David Sambol, & Eric Sieracki*, No. CV09-03994 (C.D. Cal. filed June 4, 2009), *available at* www.sec.gov/litigation/complaints/2009/comp21068.pdf.

²⁹ Mark Maremont, et. al., *Before the Bust, These CEOs Took Money Off the Table*, WALL ST. J., Nov. 20, 2008, at A1, *available at* http://online.wsj.com/public/resources/documents/st_ceos_20081111.html.

The foregoing describes criminal conduct. But even people who may not be criminally liable still might appropriately be considered somewhat villainous.³⁰ An example is a person who did not lie, but did take advantage of people with limited sophistication. Of course, we want people to be responsible for their own affairs, and not have a ready defense of non-sophistication – we certainly don't want to provide incentives for people to claim they were duped too readily. Making the behavior of those who take advantage, and may not directly lie, illegal may or may not be advisable. But we can certainly severely criticize people who developed or carried out business plans intending to capitalize on naiveté and cause significant losses.

Indeed, it seems fair to characterize these probably non-criminal “villains” as people whose plan often was, usually metaphorically but sometimes literally, to “take the money and run.” A mortgage originator making a loan that would very quickly adjust to require a payment the originator basically knew the borrower could not afford might not have been lying to anyone. (He might have been – he may very well have represented to the buyer of the loan³¹ that the loan met underwriting standards that took into account the borrower's ability to pay the loan payments as they would be adjusted; he may have assured the borrowers that the adjustments were unlikely or wouldn't be very high.) But the strategy behind such loans would seem to have been to make many of them, quickly realize large amounts of fee income, and be nowhere around when the defaults began and the buyers of the loans sought to recover on any representations that might have been violated in connection with the sale. This characterization has some resonance for the individuals who carried out strategies of their employers as well as those who developed such strategies themselves.

Of course, many mortgage brokers and originators were not villains. Indeed, there is arguably something laudable in finding creative ways to help people not eligible for prime rate financing to buy their own

³⁰ And criminal liability may exist for some who I will label non-villainous. I discuss this point in Section IV.B, *supra*.

³¹ It is possible that some intermediate purchasers, knowing that ultimate purchasers would buy the loan, might have had almost as much information as the proximate sellers. These intermediate purchasers ultimately wouldn't live to sell another day and are hence identically situated to the original sellers; for ease of exposition, I make a stylized distinction between those closer to the origination of the loan, who I lump together with the originator, and those more removed from the origination, who may have had some reason to suspect, especially as loan volume increased, that underwriting standards were being sorely compromised, but had no direct knowledge, and were getting representations they had at least some (perhaps not very good) reason to suppose they could rely on as to the loans' quality.

homes, whether one's aim is to do so for pro-social motives or simply to profit from serving an underserved market niche. The result, in an ideal world, would be to increase opportunities for such people, and decrease their lending costs, as well as giving them the ability to build up equity in a time-tested (!) asset. Competition among lenders for the business should decrease costs, as should the increasing knowledge about subprime borrowers, which should reduce the uncertainty or lemons discount. A lender could build a long-term reputation on this kind of lending. Indeed, contrast some of the old-line subprime lenders, like Beneficial Finance, eventually bought by Household Finance, which was itself bought by HSBC, with Ameriquest. Beneficial, and to a lesser extent Household, started out intending to serve an underserved market and make a respectable profit, although they later apparently started using more questionable practices.³² Ameriquest, it has been alleged, had a business plan that importantly contemplated and depended on tricking borrowers as well as loan buyers.³³

B. Appraisers and Rating Agencies

Moving along the continuum, an intermediate category encompasses people who lied or exaggerated because of pressure from an employer or client. The appraiser gives the appraisal that justifies the loan, even though she thinks the house is worth much less.³⁴ The rating

³² Press Release, Office of the Attorney General of the State of Washington, 12,000 Washington Consumers Eligible for State's \$21M Settlement with Mortgage Company (Aug. 24, 2003), *available at* http://www.dfi.wa.gov/cs/householdsettle_nr.htm ("[T]he state found Household used a combination of predatory practices to lock consumers into costly home mortgage refinancing on terms that were often unsuitable to them. These included high loan fees, extended prepayment penalties, insurance "packing" (a practice of adding various insurance products and financing them over the life of the loan), and loans exceeding the value of the mortgaged property. When consumers eventually discovered the problems with their loans, these practices made it impossible for them to refinance with other lenders.").

³³ Press Release, Iowa Department of Justice, Miller: Ameriquest Will Pay \$325 Million and Reform its Lending Practices (Jan. 23, 2006), *available at* http://www.iowa.gov/government/ag/protecting_consumers/2006_news/1_23_miller.html. None of this is to suggest that homebuyers were always exemplary themselves. Indeed, some were complicit in misrepresenting their incomes. And, where the terms borrowers accepted were unrealistic, while brokers who knew the borrowers wouldn't question such terms might be rightly criticized, we don't want to absolve borrowers of some level of responsibility. A borrower who later says she understood her 'teaser rate' to be the permanent rate of the loan perhaps should have investigated further.

³⁴ See, e.g., *Washington Mutual Appraisal Scandal*, The Mortgage Insider, <http://themortgageinsider.net/mortgage-news/washington-mutual-mortgage->

agency rates a tranche of subprime securities AAA, pointedly refusing to look at underlying documentation that would have showed that the rating wasn't warranted. Some might argue that lower-level employees who were just trying to keep their jobs are different than higher-level employees who were pressuring the lower-level employees in order to please the clients. While the distinction may have some intuitive appeal, it may be hard to articulate in a principled manner.

I consider first the appraisers. The most notorious case involves appraisers hired for Washington Mutual Bank. WaMu, as the bank was known, failed and was acquired by JP Morgan Chase in 2008; the failure was then the biggest bank failure in history.³⁵ The New York Attorney General sued a firm that hired appraisers for WaMu. The complaint alleges that:

38. By email dated February 22, 2007, eAppraiseIT's President explained to senior executives at First American WaMu's motives for demanding the Proven Panel: We had a joint call with Wamu and LSI today. The attached document outlines the new appraiser assigning process. In short, we will now assign all Wamu's work to Wamu's "Proven Appraisers" We will pay their appraisers whatever they demand. **Performance ratings to retain position as a Wamu Proven Appraiser will be based on how many come in on value, negating a need for an ROV [reconsideration of value].(Emphasis added [in the complaint])**³⁶

41. In February 2007, eAppraiseIT simply capitulated to WaMu's demands. In an email on February 22, 2007, eAppraiseIT's President told senior executives at First American "we have agreed to roll over and just do it." He explained that "we were willing to live with the change if

appraisal-scandal.html (Jan. 15, 2008 1:10 A.M. EST); Press Release, Office of the Attorney General of New York, NY Attorney General Sues First American and its Subsidiary for Conspiring with Washington Mutual to Inflate Real Estate Appraisals (Nov. 1, 2007), *available at* http://www.oag.state.ny.us/media_center/2007/nov/nov1a_07.html.

³⁵ Ari Levy & Elizabeth Heste, *JPMorgan Buys WaMu Deposits; Regulators Seize Thrift (Update1)*, BLOOMBERG, Sept. 26, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aWxliUXHsOoA&ref=home>.

³⁶ Plaintiff's Complaint at 13-14, *The People of the State of New York v. First American Corporation and First American Eappraiseit*, No. 406796-2007 (N.Y. Sup. Ct. Nov. 1, 2007), *available at* http://www.oag.state.ny.us/media_center/2007/nov/EA%20Complaint.pdf.

they would back us up with the appraisers and tell them that simply because they are rated as Gold Preferred does not mean that they can grab all the fees. They agreed.”³⁷

86....email exchanges between WaMu and eAppraiseIT show that WaMu repeatedly pushed eAppraiseIT’s ABMs to increase appraised values so that loans could close. For example, in one exchange with an eAppraiseIT review appraiser, a WaMu loan officer wrote that “Basically, if we don’t get at least the appraised value of \$3,650,000 . . . we lose the deal.” (Ellipses in original). Earlier that day, this loan officer told eAppraiseIT that “if we don’t have a definitive \$\$ appraised value then the borrower will go to another lender with a higher appraised value of \$4mm. Please . . . at least . . . keep this value at the original appraised value of \$3,650,000.” (Ellipses in original).

87. On May 23, 2007, eAppraiseIT’s Chief Appraiser described these comments as “a clear picture of Lender Pressure on behalf of WaMu.”³⁸

How do we assess the conduct of an appraiser, or an appraisal firm, that knows it is being pressured to appraise at values that are too high? The conduct may very well be criminal. But, I would argue, responding to pressure in a situation like this is different from having a business plan of the sort some mortgage brokers and originators apparently had. Lower-level appraisers who felt pressured probably would much have preferred to give appraisals they could stand behind; it seems, too, that even the upper-level executives found the pressure they were getting problematic. While bowing to pressure under these circumstances may not be laudable, it is perhaps understandable.

Rating agencies have gotten an enormous amount of negative publicity in connection with the crisis. They have been roundly vilified for giving overly high ratings. In one notorious instance, one agency, Moody’s, was caught having made a mistake in applying its own methodology—and its reaction, rather than admitting the mistake, was to revise the methodology!³⁹

³⁷ *Id.* at 14

³⁸ *Id.* at 28.

³⁹ Sam Jones, *When Junk Was Gold*, FINANCIAL TIMES, Oct. 17, 2008, available at http://us.ft.com/ftgateway/superpage.ft?news_id=fto101720081543437032. I discuss Moody’s ‘mistake’ further in Hill, *Why did the Rating Agencies Do Such a Bad Job Rating Subprime Securities?* *supra* note 18.

A recent SEC report gives a dramatic account of how rating agencies experienced themselves as pressured by their clients, and how the junior employees experienced themselves as pressured by their seniors.

The SEC report warrants being quoted at length:

“[D]ocuments in a deal file state, regarding an issue related to the collateral manager: “We didn’t ha [sic] time to discuss this in detail at the committee, so they dropped the issue for this deal due to timing. We will need to revisit in the future.” Another document describes an outstanding issue as “poorly addressed – needs to be checked in the next deal” and addresses the question of weighted average recovery rate by writing “(WARR- don’t ask ☺).” (Deal File Documents 1 & 2).

Email No. 1: Analytical Staff to Analytical Staff (Apr. 5, 2007, 3:56 PM). In another email, an analytical manager in the same rating agency’s CDO group wrote to a senior analytical manager that the rating agencies continue to create an “even bigger monster – the CDO market. Let’s hope we are all wealthy and retired by the time this house of cards falters.;o).” Email No. 2: Analytical Manager to Senior Analytical Manager (Dec. 15, 2006, 8:31 PM).⁴⁰

...a senior analytical manager in the Structured Finance group wrote “I am trying to ascertain whether we can determine at this point if we will suffer any loss of business because of our decision [on assigning separate ratings to principal and interest] and if so, how much?” “Essentially, [names of staff] ended up agreeing with your recommendations but the CDO team didn’t agree with you because they believed it would negatively impact business.”

In another example, after noting a change in a competitor’s ratings methodology, an employee stated: “[w]e are meeting with your group this week to discuss adjusting criteria for rating CDOs of real estate assets this week because of the ongoing threat of losing deals.” In another email, following a discussion of a competitor’s market share, an employee of the same firm states that aspects of the firm’s ratings methodology would have to be

⁴⁰ S.E.C., SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF’S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 12 n. 7-8 (July 2008), available at <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

revisited to recapture market share from the competing rating agency.

An additional email by an employee stated, following a discussion of losing a rating to a competitor, “I had a discussion with the team leaders here and we think that the only way to compete is to have a paradigm shift in thinking, especially with the interest rate risk.”⁴¹

The Opening Statement of Rep. Henry A. Waxman, Chairman, Committee on Oversight and Government Reform at a hearing on Credit Rating Agencies and the Financial Crisis included another rating agency internal email that is particularly telling:

In 2001, Mr. Raiter [of Moody’s Investor Services] was asked to rate an early collateralized debt obligation called “Pinstripe.” He asked for the “collateral tapes” so he could assess the creditworthiness of the home loans backing the CDO [collateralized debt obligation]. This is the response he got from Richard Gugliada, the managing director: Any request for loan level tapes is **TOTALLY UNREASONABLE!!!** Most investors don’t have it and can’t provide it. Nevertheless we **MUST** produce a credit estimate. ...It is your responsibility to provide those credit estimates and your responsibility to devise some method for doing so. Mr. Raiter was stunned. He was being directed to rate Pinstripe without access to essential credit data. He emailed back: “This is the most amazing e-mail I have ever received in my business career.”⁴²

Can rating agencies’ processes really have been as flawed and corrupt as the foregoing emails suggest? The structured finance lawyers I have spoken to, prominent people in the field, describe a more nuanced picture, in which rating agency employees seemed to be doing a mostly satisfactory job rating a high volume of exceedingly complex deals; indeed, the employees not infrequently demanded (sometimes costly) changes in the transaction structure to increase quality before giving a high rating. Even the foregoing quote provides some support for a nuanced picture: Mr. Raiter’s astonishment at being asked to rate something without reviewing important data suggests that nothing like this has happened to him before. Moreover, that investors still listen to the rating agencies’ ratings of

⁴¹ *Id.* at 25-6.

⁴² *Credit Rating Agencies and the Financial Crisis: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 3 (2008) (statement of Rep. Henry A. Waxman, Member, H. Comm. on Oversight and Government Reform), available at <http://oversight.house.gov/documents/20081022102221.pdf>.

securities today⁴³ suggests that the agencies retain considerable credibility, and argues against them having been as corrupt as has been alleged.

In a companion article, *Why Did the Rating Agencies Do Such a Bad Job Rating Subprime Securities?*,⁴⁴ I discuss the rating agencies in more detail. I argue that the accusation leveled by many against rating agencies (and apparently supported by the emails quoted above), that they were willing to sell high ratings to the issuer of securities, who was paying for those ratings, cannot in any straightforward way be correct. This is not to say that some rating agency personnel did not have significant doubts about how good a job the agencies were doing, or how high the quality of the securities was, as indicated by the emails above. But the overall picture that emerges is one in which rating agencies pretty much managed to convince themselves, as did so many market actors, that subprime securities warranted the ratings the agencies assigned to them. As time went on, the agencies may have had to work harder to remain blind to contrary indications—but, again, like other market participants, they were, unfortunately, up to the task.⁴⁵

C. Lawyers and Investment Bankers

Another intermediate category encompasses people who had some intimation that the livin' was too easy. Many lawyers and investment bankers fall into this category. They were making huge quantities of money. They were doing huge numbers of deals very quickly—too quickly to allow for a full and thorough review.⁴⁶ They probably did notice, though, that the loans they were helping securitize were being made to borrowers of steadily declining quality: with money to be made on originating loans, one could expect, and they did, if they allowed themselves to do so, that originators would dip lower into the potential pool of borrowers, making loans to borrowers they might earlier have shunned. But they also knew that the transaction structure was designed precisely to carve out some high-quality interests from pools of low-quality mortgages. After all, these were securitizations of subprime mortgages, mortgages made to people with less than prime credit. The transactions had been structured so that a pool of such loans could yield securities some of which

⁴³ See, e.g., David Gillen, *In Rating Agencies Investors Still Trust*, N. Y. TIMES, June 4, 2009, available at <http://www.nytimes.com/2009/06/05/business/economy/05place.html>; see also David Segal, *Debt Raters Avoid Overhaul After Crisis*, N. Y. TIMES, Dec. 8, 2009, available at <http://www.nytimes.com/2009/12/08/business/08ratings.html?dbk>.

⁴⁴ See Hill, *Why Did the Rating Agencies Do Such a Bad Job Rating Subprime Securities?* *supra* note 18,

⁴⁵ *Id.*

⁴⁶ The same could be said of rating agencies. See *id.*

would be of high quality. If loan quality was going down, the proportion of high quality securities issued by the pool could simply be reduced, or some other mechanisms could be used to enhance the pool's quality.

A contrast with Enron is instructive. In Enron, investment bankers were knowingly helping Enron create a false financial impression. They were designing transactions that, for instance, created "cash flow," and disguised debt.⁴⁷ What they did not know was that there were many other bankers engaged in the same endeavor. Each banker knew it was improving Enron's financial appearance, but the bankers did not get together and realize that their efforts, in the aggregate, were creating a wholly false picture. This state of affairs was orchestrated by Enron. By contrast, here, as noted above, the investment bankers weren't part of a fraud, and they certainly weren't helping anyone fool anyone else. Indeed, they (too) were probably mostly blind, although perhaps somewhat willfully so.

What about those at more senior levels, who decided on business strategy for their firms? What about the "rocket scientists" who designed the transactions in the first instance? Many of these people have significant stakes in their businesses, and lost considerable amounts of money when the market collapsed. Again, perhaps these people "should" have known that the securities they were structuring and selling were not worth nearly as much as they were being sold for, but their own stake, and consequent huge losses, suggests that they were not trying to "take the money and run." And they certainly did not succeed in doing so. While it is hard to feel much sympathy for an ex - CEO of a Wall Street investment bank who still has a considerable fortune, some of these CEOs lost truly staggering amounts of money. Many smart people staked their money and reputations on the subprime securities, precluding at least the obvious sort of villainy. In an article in the New York Times, Floyd Norris notes that:

[T]here is little evidence that big pay — or the incentives connected to it — caused the financial train wreck that sent the world into recession.

To the contrary, there is plenty of evidence that no one who counted — traders, chief executives or regulators — understood the risks that were being taken.

A new study shows that banks run by chief executives with a lot of stock were, if anything, likely to do worse than other banks in the crisis.

⁴⁷ See *Hearings on The Role of the Financial Institutions In Enron's Collapse: Hearing Before the Subcomm. on Investigations of the S. Comm. on Homeland Security and Governmental Affairs*, 107th Cong. 1 (2002) (statement of Sen. Carl Levin, Chairman, Permanent Subcomm. on Investigations).

“Bank C.E.O. incentives cannot be blamed for the credit crisis or for the performance of banks during the crisis,” states the study, by René Stulz, an Ohio State University finance professor, and Rüdiger Fahlenbrach of the Swiss Federal Institute of Technology.

“A plausible explanation for these findings is that C.E.O.’s focused on the interests of their shareholders in the build-up to the crisis and took actions that they believed the market would welcome,” Mr. Stulz said.

The chief executives were wrong, of course. Most lost tens of millions of dollars in equity value but sold few shares before the crisis hit.

Whatever else they lacked, they had plenty of incentive to keep their banks from failing.”⁴⁸

What about the lawyers? Very little has been written on the subject.⁴⁹ This should not be surprising. What was wrong with subprime securities had less to do with law than with matters more in the purview of other professionals. Still, lawyers on complex financial deals sometimes almost act like investment bankers- in a room of deal structurers, it might not be clear to a third party which person was a lawyer and which was an investment banker. Given that, and given, too, their roles simply as

⁴⁸ Floyd Norris, *It May Be Outrageous, but Wall Street Pay Didn't Cause This Crisis*, N.Y. TIMES, July 31, 2009, at B1, available at <http://www.nytimes.com/2009/07/31/business/31norris.html>. This finding is, however, not inconsistent with the idea that incentives could matter if structured to exploit the right margin. In work with Richard Painter, we argue that making executives fear personal liability for losing investments, much as partners did in investment banks before the investment banks became corporations, would cause executives to pay far more attention to downside risks, and felicitously so. See *supra* note 6. All this being said, note that in Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, forthcoming, YALE J. ON REG. the authors argue that some top executives could, and did, cash out quite a bit of money during the period at issue, and that therefore, accounts of their losses are overblown.

⁴⁹ One article about the duties of structured finance lawyers is Steven L. Schwarcz, *The Public Responsibility of Structured Finance Lawyers*, 1 CAP. MKTS. L. J. 6 (2006). Schwarcz’s article predates the bursting of the bubble, and is addressed more directly to the role of lawyers involved in structured finance transactions in Enron and other scandals of that era. Schwarcz notes that: “an opining lawyer has no general duty to evaluate the business merits of the underlying transaction beyond the obvious ethical and legal obligations of not knowingly furthering a fraudulent transaction.” *Id.* at 8. See also Steven L. Schwarcz, *Keynote Address: The Global Financial Crisis and the Role of Lawyers* (Dec. 16, 2009 working draft).

lawyers, were there a few areas where lawyers arguably should have done more, or done a better job? Perhaps the lawyers structuring mortgage-backed securities could have been more involved in due diligence on the actual mortgages.⁵⁰ As a practical matter, though, this was impossible given the deal volume presented to them. Could senior-level lawyers have refused the business on grounds that reviews couldn't be done thoroughly? Nobody else in the chain did. And were the relevant reviews really in the purview of lawyers? Arguably not. What was in the purview of lawyers was representations and warranties, and these were being given—by reputable parties.

Moreover, even insofar as lawyers might have noticed the general trend of declining loan quality, they might very well have supposed that the transaction structures were taking quality appropriately into account. As discussed above in the context of investment bankers, there is nothing problematic in theory about turning low-quality assets into AAA rated securities – one simply needs enough of the assets, and that their performance not be completely positively correlated. Surely, to provide an extreme example, a bundle of \$100 billion of subprime mortgages could yield \$1 million in AAA securities. More realistic proportions are in the range of approximately 50% to 98%, where the applicable proportion of higher rated securities of course depended on the quality of the pool and any credit enhancements used in the transaction. The lower the quality of loans in the pool all else equal, the lower the proportion of AAA rated securities the pool should- and lawyers may have thought, would- issue.

In any event, lawyers were not themselves involved in anything they knew or had reason to suppose was fraudulent or even deeply flawed. Even if lawyers might have had reason to suppose that life was a bit too good, they could plausibly conclude, as many other market participants had, that a great new financial instrument had been discovered – all they

⁵⁰ Lawyers apparently also cut corners when it came to properly conveying mortgages and ensuring that the entities to which they were being conveyed were getting title. Presumably, corner-cutting (or perhaps even a decision that the documentation wasn't really needed) because of massive deal volume is what caused these lapses- in any event, these lapses were only uncovered later, when the owners of these mortgages tried to exercise rights thereunder, and did not contribute to the problem at issue here, the issuance of subprime securities in the first instance. See, e.g. *Homeowners Take a Stand, Demand Original Paperwork*, CNBC.COM, Feb 17, 2009, available at <http://www.cnbc.com/id/29241628>; Pam Martens, *The Next Financial Crisis Starts Hitting Wall Street as Judges Nix Foreclosures*, COUNTERPUNCH.ORG, available at <http://www.counterpunch.org/martens10212009.html>.

were doing was selling it to waiting and enthusiastic buyers.⁵¹ Whatever else they were, they were not valuation experts.

D. Buyers of Subprime Securities

Moving further along the continuum, there were buyers of subprime securities who were buying just because others did, without doing thorough research. And at the other end are the buyers who did research and concluded the securities were an appropriate and attractive investment. Within this continuum are also insurers and others who took financial positions that were linked to those of the subprime securities. Insofar as an actor is making a bet that rises and falls based on the value of the securities rather than getting mostly immediate fee income, I treat her the same way I would treat a buyer.

What is there to say about the buyers? In another essay, I have argued that buyers' incentives in the face of considerable uncertainty are to make sure not to miss out on the "hot thing." If the "hot thing" turns out to not be so good, they do not look worse than other money managers. Their downside is, therefore, limited. However, if the "hot thing" is good and they have not bought it, they look very bad by comparison.⁵² Of course, if it is clear to a prospective buyer that others are under a collective delusion, things change. Indeed, some investors made enormous amounts of money betting against subprime securities.⁵³ But apparently, many buyers concluded that subprime securities were not obviously so bad that they were willing to buck a popular trend.

Some of the literature argues that buyers who held onto a larger portion of the gains from their investments made better decisions, purchasing fewer subprime securities. In particular, hedge funds, not restricted by statute from getting generous performance-based fees, it is argued, were not big buyers of subprime securities.⁵⁴ Empirics are not

⁵¹ This discussion is based on interviews with several leading structured finance lawyers.

⁵² Hill, *supra* note 3, at 9-10.

⁵³ See, e.g., *The Wall Street Investor Who Shorted Subprime – and Made \$15bn*, MONEYWEEK.COM, available at <http://www.moneyweek.com/news-and-charts/the-wall-street-investor-who-shorted-subprime-and-made-15bn.aspx>.

⁵⁴ Charles W. Calomiris, *The Subprime Turmoil, What's Old, What's New, and What's Next* (Oct. 2, 2008), available at www.kc.frb.org/publicat/sympos/2008/Calomiris.10.02.08.pdf; written testimony submitted to the H. Comm, on Oversight and Government Reform by Houman B. Shadab, *Hedge Funds and the Financial Market* (Nov. 13, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1302705. It is also not clear why money managers, who are compensated largely on the amount of funds under

definitive on this point, but it does seem that hedge funds were big insurers of the securities, making a bet that relied as well on the securities' value. And whether or not super-charged incentives in the form of performance fees buy more fealty to the investors' interests, at least in one case they do not seem to have bought much in the way of competence.

“Donald Uderitz, [manager of a hedge fund that ‘sold insurance’ on a CDO], says he believed there was little likelihood of having to pay out insurance to cover losses from the CDO. In an interview, he says he bought the investment to earn the fees the banks would pay the hedge fund, equal to 5.5% of the \$10 million notional amount of the swap from Citigroup and 2.75% from Wachovia. Mr. Uderitz says he feels “suckered” [by having to actually pay out on the insurance].⁵⁵

Judging from how much insurance was written on CDOs and other instruments now implicated in the crisis, we may speculate that perhaps Mr. Uderitz's sentiment was not so uncommon.

V. CONCLUSION

The foregoing suggests the limitations of traditional legal tools to prevent or minimize the next crisis. Preventing, or minimizing the likelihood or severity of, the next crisis, can't be accomplished purely or even principally by making now-legal behavior illegal or making now-illegal behavior more illegal. What the villains did was already largely illegal. Mortgage brokers who lied about the income of homebuyers to make them qualify for loans were committing fraud — both those in cahoots with the buyers and those not in cahoots. Homebuyers who lied

management, would not both want to increase the size of those funds, by doing well in their investments, by discouraging present investors from withdrawing funds, and by encouraging investors to give them additional funds. Maybe the hedge fund managers get more of what they earn, but why should that be the margin that makes the difference? Ordinary money managers would seem to have significant incentives to do as well as they can. One principled difference might be if hedge fund returns are not subject to ‘benchmarking’ the way that many investment funds that are not hedge funds are—the hedge funds would then be less, or not, subject to herding incentives than non-hedge funds would be.

⁵⁵ See Susan Pulliam, Serena Ng & Tom McGinty, *Insurance Held Hidden Risks, A Fund Claims; Citigroup, Wachovia Face Suits Involving Credit Default Swap Skirmish: Risks Hidden, Says Hedge Fund*, WALL ST. J., Mar. 4, 2008, at C1, available at <http://online.wsj.com/article/SB120459196434709061.html>. See also Susan Pulliam, et al., *Citigroup and Wachovia Hit with Lawsuits*, WALL ST. J., Mar. 4, 2008, available at <http://www.efinancialnews.com/usedition/index/content/2449970046>.

about their income or other matters to qualify for loans were committing fraud. The same can be said about appraisers pressured by lenders or brokers into making willfully false appraisals on properties to support loans on those properties, and lenders who quickly sold the loans they had made, making false representations to those purchasing the loans and about the loans' quality. Making this conduct more illegal won't serve any purpose, nor will throwing resources at detecting the type of behavior at issue. Nobody is making loans without verifying borrower income now, nor are such loans expected to be made in the foreseeable future. Appraisals are very conservative nowadays. There will always be actors ready to violate laws — enforcement is never perfect, and the opportunity will always exist to take the money and run, as many of the villains contemplated doing (and some managed to do). Indeed, attempts to recover from the villains haven't achieved much. They clearly committed fraud, but mostly don't have the assets to pay penalties for breach. Many of the businesses in question — mortgage brokers or banks that made questionable mortgages — have gone into bankruptcy or otherwise disappeared.

We also can't succeed just by using straightforward fixes in the top drawer of the economists' toolkit, such as aligning incentives. There were certainly misaligned incentives. But the parties with the strongest incentive to check the quality of the instruments that are now called "toxic securities," the buyers of those instruments, didn't do so. To some extent, we can explain this consistent with traditional theory. The valuations of these instruments nowadays are lower than could reasonably be expected: an unprecedented vicious circle of unemployment, deflation, and panic has occurred. And some of the purchasers of these instruments might have been agents purchasing for others, with incentive structures favoring quantity over quality.⁵⁶ But traditional theory still leaves a great deal unexplained.⁵⁷ The securities were overpriced by any sensible metric, especially as the instruments were reaching their peak valuations (and credit quality was declining precipitously), and many of the purchasers, including many agents buying for their principals, had significant incentives to avoid buying overpriced instruments.⁵⁸ The monetary cost to buyers of

⁵⁶ But this seems rather unlikely unless an agent is counting on a quick performance bonus and a quick exit soon thereafter. Many agents are compensated based on money under management. A losing investment will yield less of a return, as will a pool from which some investments have been withdrawn on account of their poor performance and no new investments are being made on account of a reputation for poor performance.

⁵⁷ *But see supra* note 5.

⁵⁸ An obvious question to be asked is about not just the purchasers/investors, but the arbitrageurs who might have bet against the value of the instruments. Where were they? Why didn't they bet more aggressively that prices would "return to fundamental value"? How could these instruments have stayed overvalued given

instruments backed by subprime mortgages, and the monetary and reputational cost to those involved in packaging, selling, and rating those instruments, is considerable. There are probably some short-term actors among these non-villains — people who suspected strongly that they were in a bubble, and hoped to profit before the bubble burst. But this isn't just a simple story of agency costs and a bubble badly mistimed. Many investors with considerable downside exposure and without a viable exit strategy eagerly bought these securities at the asking price. Putting much stock in a solution based on aligning agents' incentives with those of their principals thus seems unduly optimistic.

In another essay,⁵⁹ I argue for one solution: a push, through norms and perhaps through regulation, to encourage (or require) investors who are investing for others to make individualized assessments as to their investments, and not hide behind rating agencies or other investors' assessments. As I explain in that essay, the crisis could not have occurred had investors not been willing to buy the instruments backed by subprime mortgages. It's often pointed out that those originating the mortgages felt free to increase quantity at the expense of quality because they'd be selling the mortgages, and wouldn't suffer losses from lower-quality mortgages. But the reason they wouldn't suffer losses was that they were able to sell the mortgages at prices closer to those appropriate for high-quality mortgages. The moral hazard is palpable, including to investors. Why weren't they looking at the instruments more critically? One answer they sometimes give is "the rating agencies gave the instruments high ratings." But Enron isn't in the distant past, and investors were on record even before Enron as saying they didn't think much of rating agency aptitudes.⁶⁰ My

the ability of market participants to make bets in both directions? Even if there were overzealous buyers, why weren't there many zealous 'sellers'? Some commentators conclude the instruments must have been correctly valued given that there were no regulatory obstacles to short-selling or its equivalent. But most commentators, and the overwhelming weight of common sense, reject this conclusion. Somehow, more money was thrown at overvaluation than bringing the prices down to earth. Once Keynesian dynamics are thrown into the mix — what people want to do is figure out what others are doing, and enough people proceed in this manner that identifying instruments that are overvalued relative to their "fundamental value" actually becomes, or is reasonably perceived to be, rather risky relative to its rewards — the puzzle can be solved. Or, alternatively, an important part of the story may simply be complexity now somewhat disguised by hindsight bias. In prospect, that financial engineers (so-called "rocket scientists") should have successfully designed instruments that had the attributes these were touted to have wasn't completely ludicrous.

⁵⁹Hill, *supra* note 3.

⁶⁰I also argue in that essay, Hill, *supra* note 18, though, that rating agencies weren't as distrusted post-Enron as the pre-Enron skepticism and performance in Enron might indicate. Thus, my claim is not that investors didn't rely at all on

answer, as explained in the companion essay, is that investors felt comfortable doing what other investors were doing. Hence my suggestion that that source of comfort needs to be eliminated, or at least significantly minimized.

Other proposed solutions include better monitoring of “systematic risk,” limits on leverage for banks, limits on size of banks, and adjustments of compensation structures of investment bankers. The typical proposal as to the latter is that compensation be made more long-term. With a co-author, I have elsewhere argued that changes to upside compensation are not enough – that exposing well-compensated financial firm managers to some amount of personal liability may be called for.⁶¹ Tractability and political feasibility are big issues for all of these proposals. But perhaps the crisis will provide us with an opportunity to consider solutions that might, but for the crisis, have been unthinkable. As President Obama’s Chief of Staff, Rahm Emmanuel, has said: “You never want a serious crisis to go to waste....This crisis provides the opportunity for us to do things that you could not do before.”⁶²

rating agencies, but that their reliance wasn’t sufficient to counter the red flags a critical mindset would have revealed.

⁶¹ See Painter & Hill, *supra* note 6.

⁶² Gerald F. Seib, *In Crisis, Opportunity for Obama*, WALL ST. J., Nov. 21, 2008, at A2, available at <http://online.wsj.com/article/SB122721278056345271.html>.

